United States Department of State

Economic Reform in Poland: Status and Prospects

September 1989

United States Department of State

Economic Reform in Poland: Status and Prospects

September 1989

Economic Reform in Poland: Status and Prospects

Summary

The new Solidarity-led government of Premier Tadeusz Mazowiecki has inherited an economy in crisis. In addition to the immediate problems of consumer goods shortages and inflation, economic performance suffers from formidable problems of industrial obsolescence, weak infrastructure, bad management, and low labor productivity. The stifling system under which Poles have labored for decades—and which they now have the opportunity to change—has left goods noncompetitive in export markets, limiting Poland's ability to modernize through imports or to service its crushing $39 billion debt.

Poland's economic plight has many roots—in the characteristic shortcomings of centrally planned economies; in mismanagement of development and import strategies; in efforts to placate worker unrest stemming from worsening living conditions; and in the shortcomings and inconsistencies of economic reform efforts of past Communist regimes. However, Poland is now laying the groundwork for dramatic new progress.

The new government has announced its intention of making economic stabilization its highest priority. Among its immediate tasks are bolstering food supplies and reining in the state budget. Success on these fronts will help garner worker support for economic reform measures that understandably will also mean uncertainty and hardship. The reforms also offer Poland a chance for improving living standards and—more important—for nourishing the seeds of democracy recently sown in Poland. At the same time, Poland also has to move quickly on developing an economic recovery program with the IMF.

In the long run, Poland faces the challenge of revitalizing and restructuring its obsolescent economy and restoring its international creditworthiness, while avoiding a further deterioration of living standards likely to jeopardize stability. Solidarity has said it intends to push forward a comprehensive package that reforms or privatizes state industry while encouraging new private industry—both foreign and domestic—as well as agricultural expansion. Poland must increase hard currency exports, develop capital markets, and encourage domestic savings.

The ability of the Mazowiecki government to retain good will, build public confidence, and convince the Poles that its reforms are more than just another set of consumer price hikes is crucial to its chances for success. The timing of reforms will be important if Mazowiecki is to avoid the mistakes made repeatedly by previous regimes. The government must lay the groundwork for a systematic reform of state-sector industry before moving too quickly to greater reliance on market mechanisms. Critical elements of this process will be dismantling central ministries, securing enterprise management compliance with reforms, legislating unemployment benefits, and privatizing at least part of state industry.

Mazowiecki also must be able to point to widespread support from the West in his efforts; most Poles realize that any significant restructuring of the economy will require infusions of financial and technical assistance that only the West can provide. Ideally, such aid should be linked to reform progress, both to avoid a repeat of Poland's borrowing mistakes of the 1970s and to help the new government justify any attendant hardships for workers and consumers.

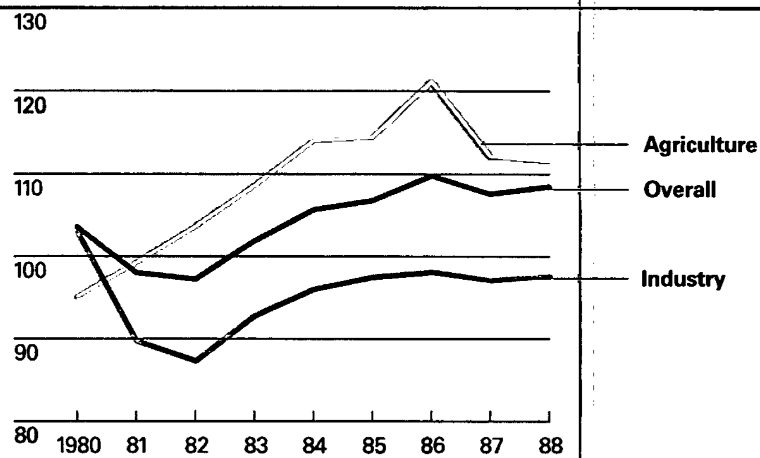
Contents

POLAND

1. Selected Growth Indicators

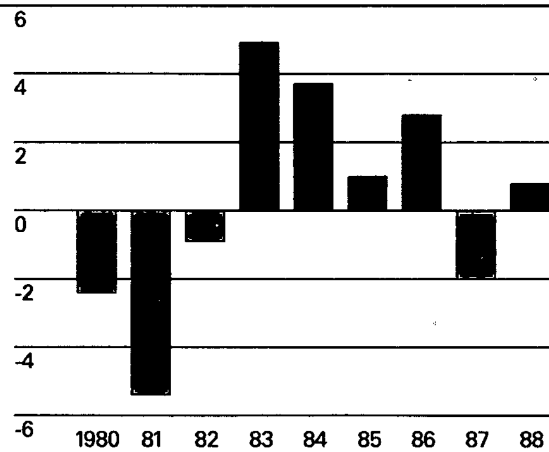
Selected GNP Indices, 1980-88

Index: 1975=100



Real GNP Growth, 1980-88

Percent



Economic Reform in Poland: Status and Prospects

Overview of Poland's Economic Performance

Poland's economic performance in the 1980s has been weak, and the decline has worsened in 1989. Real per capita income remains 10 percent less than a decade ago, and growth in the 1980s has brought output back only to the levels preceding the 1980-81 crisis. Inflation, spurred by price hikes last year and two subsequent waves of strikes, has risen from 70 percent annually at the beginning of 1989 to nearly 200 percent annually by midyear. Industrial output in the first half of 1989 was up only 1 percent and actually declined in the second quarter. Food deliveries appear to have increased this year, but panic buying and hoarding spurred by fears of even greater inflation have kept store shelves bare. The decontrol of food prices on 1 August propelled consumer prices upward and triggered further strikes, often for 100-percent pay increases, despite legislation promising to compensate workers fully for higher food costs.

A survey of financial macroeconomic indicators shows that:

- The state budget deficit has skyrocketed and now is nearly 55 percent of total revenues. The 1988 deficit was 200 million zloty; 1989's budget forecast a 1-trillion-zloty deficit; by May the deficit had reached 2.7 trillion zloty and even recent official forecasts for a 6-trillion-zloty deficit—in real terms, about triple the original forecast—now appear optimistic.

- Poland's money supply jumped over 60 percent in the first five months of 1989, from 2.7 trillion zloty to 4.4 trillion, as government expenditures ballooned—especially on consumer goods subsidies—while revenues fell behind schedule; enterprises struggling with new tax schedules and increased wage demands are increasingly behind on their taxes.

As a result, the value of the zloty has fallen dramatically in 1989. The official exchange rate rose from 503 zloty to the dollar in January to 1,350 in September. Although private sales of foreign currency have been legalized, the December 1988 black-market rate of 2,000 zloty to the dollar gave way by September to a commercial rate of 1,100 zloty to the dollar. The dramatic fall of the zloty has encouraged panic buying and hoarding as people buy hard currency and consumer goods as hedges against inflation.

A Sector-by-Sector Evaluation of the Economy's Problems

Poland's economic performance reflects the problems rife in virtually every economic sector. Industry is obsolescent, agriculture is constrained by a lack of inputs, trade is too low to finance modernization through imports, and private enterprise (outside of farming) and foreign investment are still too small to make a dent in Poland's economic problems.

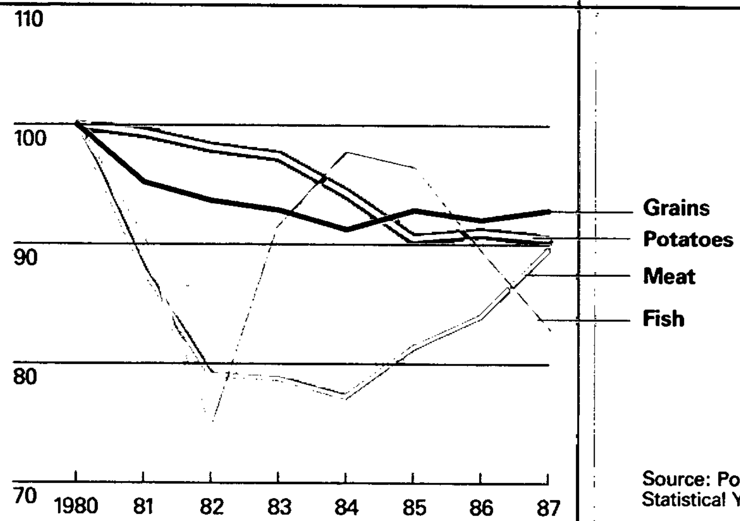
Industry—The State Sector

Stalinist development strategies led to the development of a large state-owned manufacturing sector that produces 94 percent of Poland's nonagricultural output. Much of Poland's industry is concentrated in obsolete heavy industry. Most sectors are characterized by a handful of large enterprises—there are only 2,300 state enterprises in Poland, with as many as 10 establishments each—operating out of outdated factories that are extremely wasteful, are often heavy polluters, and produce low-quality goods uncompetitive on world markets. According to the World Bank, Polish factories on average use 2.5 times as much fuel and power per unit of output as do their Western counterparts. Moreover, declining investment allocations have led to capital stock wearing out faster than it can be replaced, and foreign exchange shortages limit imports of modern technology and even spare parts. Some plants have a net worth that is zero or negative by Western calculations, but they are kept operating in order to meet plan or trade commitments.

POLAND

2. Per Capita Consumption Indices

Index: 1980=100



Source: Polish Statistical Yearbook

Table 1
Poland: Wage Growth and Cost-of-Living Increases, 1981-88

Percent

	1981	1982	1983	1984	1985	1986	1987	1988 [a]
Nominal wage growth	27.3	51.3	24.5	16.3	18.8	20.4	21.1	84.4
Cost-of-living increase	24.4	101.5	23.1	15.7	14.4	17.3	25.5	74.0
Real wage growth	2.3	−24.9	1.1	0.5	3.8	2.6	−3.5	6.0
Per capita consumption growth [b]	NA	NA	NA	4	4	2	2	2

[a] Preliminary.
[b] Of goods paid for out of incomes (net of subsidies).

Source: Polish Statistical Yearbooks, statistical communiques.

State industry also is characterized by chronic and concurrent underemployment and labor shortages, the result of labor hoarding by factories more interested in meeting plan targets than in minimizing production costs. In 1988, for example, only 5,000 people were officially listed as looking for work, even while the state listed 280,000 job vacancies. In most state plants, however, many workers are idle much of the day. Education and training are readily available, and workers are free to change jobs, but Poland's housing shortages restrict labor mobility.

Domestic investment in state industry has tended to maintain heavy industry rather than to restructure the economy. Investment historically has been shaped by central planners and autonomous bureaucracies rather than by interest rates and profit potential. Until the 1980s most investment allocations came from direct grants from the state budget that did not need to be repaid. Ministries controlling the most physical assets—and which could make the most persuasive case for new investment in order to meet production targets—received the bulk of the annual state budget's investment allocations. As a result, Warsaw over the years has squandered considerable money in building and maintaining heavy industrial facilities of questionable worth.

The Poles readily acknowledge that a large part of the industrial base should be scrapped, but there is no ready substitute for what most of these plants produce. For example, even though the huge Nowa Huta plant uses inordinate amounts of energy supplies to produce steel, a shutdown either would require hard currency imports of steel well beyond what Poland can afford, or would mean steel shortages for other industrial plants that may be more efficient or productive.

Industry—Private Enterprise

Despite rapid growth in the 1980s the private sector in Poland still contributes only a small share—6 percent—of nonagricultural output. In addition to such traditional nonindustrial areas of operation as handicrafts, trade, and services, private enterprise now operates in such areas as small-scale manufacturing, transport, and even computer software and consulting. Poland's private-sector work force (not including 4 million private farmers) increased from about 600,000 in 1980 to just over 1 million by 1987, according to official statistics.

Private industry's growth probably would have been greater if not for numerous obstacles to its operation. Until this year privately owned enterprises had been heavily taxed and subjected to a 50-workers-per-shift ceiling on employment. Private enterprise also has suffered from bureaucratic obstacles—cumbersome registration and licensing procedures—and discrimination in favor of state enterprises for goods and services in short supply.

Agriculture

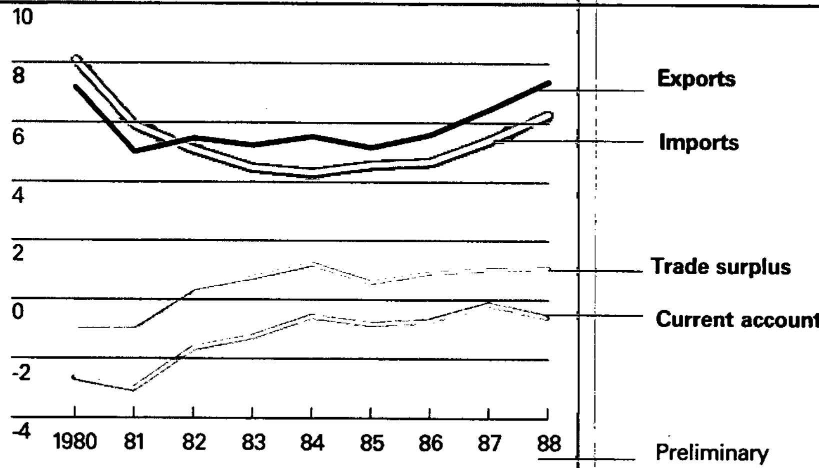
About 80 percent of Poland's agricultural lands are privately held—the result of failed collectivization efforts in the 1950s—which is the highest proportion in the Soviet

POLAND

3. Selected External Financial Indicators

Hard Currency External Accounts, 1980-88

Billion US $



Debt Coming Due 1989-95
(Principal Only)

Billion US $

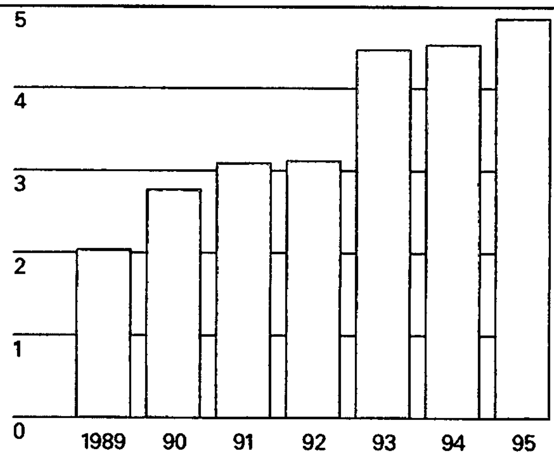


Table 2
Poland: Central Government Subsidies, 1983-88

Current billion zloty
(except where noted)

	1983	1984	1985	1986	1987	1988
Total	**1,140**	**1,487**	**1,721**	**2,108**	**2,688**	**3,320**
Producer subsidies	564	738	861	925	997	867
Consumer price subsidies	576	749	860	1,183	1,691	2,453
Share of budget expenditures (*percent*)	40.0	41.4	31.6	39.7	42.1	33.2

Source: Polish Statistical Yearbooks.

Table 3
Poland: Pollution and Waste Problems

Million tons
(except where noted)

	1975	1980	1986
Industrial dust emissions	18.021	25.77	27.259
Industrial gas emissions	0.563	0.664	0.677
Hazardous waste produced	136	165	179
Of which is stored:	66.2	78.5	85.4
Percent stored	48.7	47.6	47.7

Bloc. Farmers are constrained, however, by several factors. Restrictions on sales of land have kept farm sizes too small to capitalize on economies of scale; farm incomes have remained substantially—15 to 20 percent—below those of urban workers. A chief complaint of private farmers is that their ability to make a living is constantly squeezed by low procurement prices and high input prices. Moreover, the state monopoly on supply of agricultural inputs has inhibited private-farmer access to fuel, feed, and fertilizer. These inputs are not available in sufficient quantity to meet demand, and state farms typically receive preferential treatment in distribution. Another factor holding back agricultural output has been insufficient state investment in agricultural infrastructure; a lack of storage and processing facilities is responsible for large losses of harvested goods through spoilage.

Foreign Trade

Poland's foreign trade is modest for an economy of its size; total exports generally have made up about 15 percent of output through the 1980s, with about half going to Communist countries and half to the West. A sharp falloff in hard currency trade after Western trade sanctions were imposed when martial law was declared has been followed by near recovery to precrisis trade levels (see figure 3).

Poland has managed to maintain about a $1 billion trade surplus in recent years to help service its foreign debt. This has been done more by restricting imports than by expanding exports. The clampdown, however, has cut off access to badly needed inputs, spare parts, and repair services, thus limiting growth prospects for production and exports. Other factors limiting Polish export performance are poor product quality and weak world demand for Poland's leading exports, like coal and copper, which affect particularly Poland's ability to expand trade with the West. Poland's distorted price system, the overvaluation of its currency, and its trade obligations within CEMA also have worked against developing consistent efforts to increase hard currency earnings. Central authorities generally target goods for export to the West after netting out expected internal needs and CEMA trade obligations. Handling of exports by foreign trade organizations has tended over time to limit enterprise awareness of potential export markets and products.

Restrictions on export earnings also have worked against export growth. Hard currency restrictions have tended to discourage enterprises from seeking export markets; exporters receive only a small share of the hard currency earned by their exports, with the lion's share converted to zloty at the undervalued official rate. As a result, enterprises often have earned more zloty from domestic sales than from exports.

Hard Currency Debt. Poland's hard currency debt stood at $38.9 billion at the end of 1988—the highest in Eastern Europe. It has burdened the economy with debt service commitments ranging from $2-4 billion annually, and the failure of previous Polish governments to service this debt has precluded a renewal of access to new hard currency loans. Poland typically maintains a trade balance of about $1 billion, which usually helps to cover about 30 percent of its yearly repayment obligations. Polish leaders in effect have chosen to alienate creditors rather than to further curtail imports of capital goods.

Through the 1980s, Poland has managed to arrange reschedulings of its debt with both commercial and official (Paris Club) creditors. Failure to meet their commitments, however, has prevented past Polish governments from obtaining new credits to modernize or refurbish industry and to promote export expansion. Given Poland's dismal track record, Western creditors have been reluctant to extend new credits until Warsaw arranges an IMF standby agreement. A standby would give Poland access to IMF credits, but would also require Poland to subscribe to an adjustment program that includes economic reform measures.

The Evolution of Poland's Economic Problems—A History of Failed Reforms

By the end of the 1940s, Poland had established a centrally planned economic system on the Soviet model, with state-owned industry and central planning of production and trade. It embraced the typical Stalinist development model of rapid industrialization through high investment in heavy industry. It helped Poland emerge from wartime devastation, but soon gave rise to serious market imbalances, slowdowns in productivity growth, shortages of both production and consumer goods, inefficient use of technology and materials, and declining quality of production.

Communist leaders launched efforts to establish a more decentralized and market-oriented economy in 1956, 1974, 1982, and 1987. In each case, the central bureaucracy was able to regain control over economic decision making that had been transferred to the local or plant level. This was largely because of resistance on the part of the *nomenklatura*—local officials and managers appointed on the basis of party political credentials rather than economic or technical expertise. They have been generally opposed to reforms or unable to adjust to them, and have readily acquiesced in central ministry overtures to recoup authority.

In the 1970s, mismanagement of foreign debt helped undermine Poland's first attempt to look to the West for help. Taking advantage of the openings provided by Soviet-US detente, the government borrowed heavily from official and commercial creditors. The Gierek regime opted for a development strategy that relied on loan-financed imports of technology and equipment to develop new export industries. Warsaw counted on projected later growth in hard currency exports to repay the loans and speed Poland's modernization.

This development strategy failed for several reasons, some the result of Polish miscalculations and some the product of events beyond the control of Polish planners. In the former category, Poland failed to coordinate its various loans, and the surge in project construction created shortages and bottlenecks. Loans often fell due before plants were completed. Moreover, Polish ministries frequently imported inappropriate or incompatible technologies or failed to accurately assess export potential. Followup costs in imported materials or services frequently were overlooked, and output quality often was not suitable for export. In the latter category, projected new markets often failed to materialize because of reduced market demand from a recession-plagued West and unexpected competition from Asian newly industrializing economies. Similarly, a fall in world prices hurt Poland's hard currency earnings from its traditional exports of coal, copper, and sulphur.

Mounting foreign debt problems—debt soared to $25 billion by 1980—forced drastic cutbacks in imports of producer goods and imposition of austerity measures that placed great stress on the work force. Development of the

Solidarity movement in the period 1980-81 also contributed to social and economic disruptions that led to recentralization of economic decision making.

1981-86: The "First Stage" of Economic Reform

Objectives and Strategies. Following the imposition of martial law in 1981, Polish leader General Jaruzelski mounted another attempt to reform and revitalize the economy by decentralizing decisionmaking authority and introducing market mechanisms in the state sector. He apparently hoped he could make the *nomenklatura* respond to profit incentives and to market signals without excessively weakening party influence over economic decisions.

The 1981 Reform Project laid out proposals to incorporate a number of market-type mechanisms in the economy while scaling back the planning apparatus:

- Enterprises were to be "self-financed," meeting costs out of revenues and borrowing with interest from banks to finance expansion.

- Enterprises were to be "self-reliant," making their own production decisions, setting wages, and hiring and firing workers. Central ministry authority would be curtailed and the central plan scaled back to such priority areas as defense and CEMA trade commitments.

- Enterprises were to embrace worker "self-management," giving workers a voice in decisions at all but about 100 strategic plants.

Problems in Implementation. Despite a promising start, the Jaruzelski government failed to follow through in what came to be called the "first stage" of economic reform. Opponents of reform in the central ministries succeeded in watering down or eliminating a number of legislative proposals. Moreover, as problems later arose in implementing the laws that passed, the bureaucracy was able to modify policy to suit its needs. For example, financial reforms were intended to make enterprises cover their expenses out of revenues while paying a share to the state in taxes; money-losing enterprises eventually could be declared bankrupt and be shut down. The *nomenklatura*, however, managed to eliminate the threat of bankruptcy for most enterprises. Managers of money-losing enterprises asked for and received central ministry support in securing modified tax rates, special industry-specific exemptions, and other forms of special treatment.

Other efforts to impose financial discipline on enterprise managers also went astray. The Jaruzelski government shifted much of Poland's funding of investment projects from direct budget grants to bank loans that had to be repaid with interest. Over time, however, rate subsidies for "preferred" projects became the norm; few loans carried a real interest cost after accounting for inflation. Moreover, enterprises suffering unexpected shortfalls in revenue frequently could tap central ministry slush funds or lobby for refinancing.

Because of the imperfections in producer goods markets—shortages persisted for many goods—enterprise managers supposedly free to determine output generally found they had to bargain with various state ministries for needed raw materials. Over time this practice consolidated the power of the central ministries—who were best able to broker commodities in short supply—over individual enterprises. Lack of progress in decentralizing state control over the economy was not entirely the product of intent or ill will—inexperience with Western concepts of cost accounting or marketing encouraged many of the *nomenklatura* to stick with procedures and relationships they knew. Similarly, many enterprise officials uncomfortable with new responsibilities found ministerial intervention a benefit.

Over time, reforms promoting worker self-management also were reversed. The list of "critical sector" state enterprises in which workers' participation in management was legally restricted grew from 100 initially to over 2,000.

Results. Despite the initial flurry of legislation and attention to reform, over time it became clear to the *nomenklatura* that entrepreneurial incentive rarely was rewarded, nor was the costly hoarding of labor and materials often penalized. As a result, although Poland moved away from the traditional operating mode of centrally planned economies and direct bureaucratic controls, its indirect levers—tax and loan policies, market mechanisms, and the like—often failed to work properly, and in many cases they were ultimately supplemented or replaced by indirect bureaucratic controls.

By 1986 it had become clear that a reestablishment of central control over economic processes had taken place. The World Bank, however, notes that a number of significant changes did occur:

- The still-small private sector had been given legal status and was growing rapidly.
- Areas in the economy subject to direct commands had been reduced, though not nearly as much as intended.
- Use of market mechanisms had grown in scope and quantity.
- The economy had become marginally more open to foreign trade.
- Banking and credit system reforms led to at least partial distribution of investment capital through loans rather than grants.

1986-88: "The Second Stage" of Jaruzelski's Economic Reform

In 1986, General Jaruzelski revived plans to move ahead with the "second stage" of economic reforms. His motivations probably included the perception that living standards were declining and would eventually lead to unrest; that economic growth was slowing as Poland returned to production levels of the late 1970s; that Poland was falling further behind the West in living standards and in international competitiveness; that the West might soften its post-martial-law stance vis-a-vis Poland and again provide financial assistance if reforms proceeded; and, finally, that Gorbachev's program of *perestroyka* in the Soviet Union would help undercut the Polish hardliners who had opposed economic reforms on ideological grounds.

The second-stage reform consisted primarily of a restatement of unfulfilled first-stage objectives: enterprise self-management and self-funding; reduced party and central ministry influence; and greater reliance on market mechanisms. The second stage also sought to deal with emerging problems of a hybrid system and cited the need for:

- Tax reform.
- Breaking up large conglomerate enterprises to increase competition.
- Introducing more effective bankruptcy procedures to allow shutdowns of poorly performing enterprises.
- Imposing real interest rates to attract savings and put a real cost on borrowing.
- Phasing out subsidies on producer and consumer goods.
- Creating joint-stock companies.
- Restructuring the economy away from heavy industry to light industrial production, both to meet consumer needs and to develop new exports.

In mid-1987 the architect of Jaruzelski's reform, Deputy Premier Zdislaw Sadowski, presented a program and timetable for over 120 specific proposals and objectives. A national referendum apparently designed to give the reform the cachet of public support and to undercut reform opposition within the government backfired when worker cynicism over proposed price hikes led to a low turnout. The defeat of the referendum led to a government decision to raise prices incrementally over three years in an effort to reduce distortions and to create profit margins for enterprises that might spur increased production.

Workers responded to the first installment of price hikes in February 1988 with strikes and job actions which gave them wage increases well in excess of productivity gains and increased consumer prices. Most enterprises passed on increased labor costs by raising product prices, or they sought debt or tax relief. The increasing strains on the system aborted Sadowski's reform initiatives. As financial discipline broke down, accelerating inflation and another wave of strikes led to the resignation in September 1988 of the government of Premier Messner.

1988-89: Rakowski's Reform Efforts: Promising Beginnings . . .

Facing an increasingly aggressive labor force, the Rakowski government initially took a proreform stance and pledged to increase food supplies and accelerate housing construction. The government bolstered consumer goods supplies with immediate hard currency imports totaling $60 million, with another $240 million earmarked for equipment imports for consumer goods industries. Warsaw also raised farm procurement prices—retroactive several months—to placate farmers and stimulate agricultural production.

The Rakowski government also sought to promote private enterprise and foreign investment and to reform state-sector industry by breaking up large conglomerates. Ministerial appointments included reformers and proponents of private industry. New legislation sought to encourage more rapid growth in private enterprise by:

- Eliminating restrictions on the number of workers that could be employed.

- Lowering the basic tax rate on profits from 75 to 50 percent.
- Promising equal access to bank credits and material inputs.
- Streamlining registration procedures for new enterprises.
- Limiting central ministries' jurisdictions over private enterprise to matters of export restriction.

Legislation designed to encourage foreign investment also eliminated or reduced many restrictions on Western businessmen. In addition to having permission to establish joint ventures with either private or state-owned establishments, foreign firms can also set up fully owned subsidiaries.

Rakowski also enacted legislation that:
- Lowers the basic tax rate on profits to 40 percent from 50 percent, with tax rates on export earnings as low as 10 percent.
- Exempts enterprises with foreign participation from taxes during their first three years of operation.
- Grants joint ventures in priority areas an additional tax holiday of up to three years.
- Permits enterprises with foreign participation to repatriate up to 85 percent of their hard currency earnings (they must sell the remaining 15 percent to the Polish Government at the official exchange rate).
- Allows Polonia firms—small ventures headed by Polish expatriates—to convert to joint venture status to enjoy the more flexible provisions of the new law.

And Ultimate Failure

Despite promising beginnings, the Rakowski government faltered. Efforts to limit wage growth, budget deficits, and inflation were put off until an overall reform package could be drafted. But, the promised new program—"The Plan of Consolidation for 1989-1990"—never moved beyond the stage of deliberation. Efforts to control inflation and cope with a worsening economy remained on hold as political dialogue took precedence over economic policy.

It was at this point that the government more actively sought Solidarity's participation in economic policy making in hopes of increasing both public tolerance of needed austerity measures and trust in the government. These overtures led to the Roundtable talks in March 1989. Agreement was reached on political issues, but neither side was willing to press for economic reforms that would involve hardships likely to provoke unrest. The agreements that were reached—to cut the deficit, to reallocate budget spending, and to decontrol prices—were vague on timing and specifics. The most concrete agreement—to index worker wages to inflation—actually ran counter to the goals of reform. Political issues have continued to take precedence over economic questions, first in the runup to the elections, then in the maneuverings that preceded the nomination of Tadeusz Mazowiecki as prime minister, and finally in the bargaining that led to the formation of the new cabinet.

Lessons for the New Government

The new government under Mazowiecki has inherited an economy that is increasingly dysfunctional, operating in uncharted waters between central planning and market mechanisms. The history of repeated failures to reform the economy, however, provides clear indications of mistakes to avoid in the future. First, the Poles must break the cycle in which reform initiatives are undermined and circumvented by central ministries and state enterprises reluctant to adopt new patterns of economic behavior. Second, Polish reformers must do a better job of selling reforms to the public. Previous reform efforts have not followed through on meaningful profit, wage, or hard currency incentives for farmers, workers, or managers.

What Poland Needs To Do

The Mazowiecki government will have to consider steps to stabilize Poland's economy before attempting reforms, and recognize that some reforms will take longer than others to formulate and implement. Economic reform policy can be viewed in terms of Poland's immediate, midterm, and long-run needs.

Immediate Measures
An early stabilization of the economy is important, both to minimize unrest and to lay an effective foundation for future reform efforts. Controlling inflation, drastic budget cutbacks, and improvements in consumer supplies are of critical importance.

Inflation. The government will have to address accelerating inflation without delay. At this point, the chief source of inflation is uncontrolled government spending which stems from an explosion of subsidies on consumer and producer goods. Although decontrol of food prices probably will moderate the strain on the budget from consumer subsidies, the full impact of recently won wage concessions has not yet been felt. Before the end of 1989, increasing numbers of enterprises that have capitulated on wages probably not only will fail to deliver delinquent taxes, but will seek bailouts from the central budget just to meet their payrolls.

Warsaw has several options for slowing government spending. In order of increasing difficulty, they include:
- Sharp cutbacks or a complete freeze on budget outlays for investment and construction (except perhaps housing), as well as further reductions in defense spending.
- Reduction or elimination of central ministry functions and funding.
- Modification or elimination of wage indexation.
- A freeze or reductions in budget outlays for subsidies to both enterprises and consumers.

Sharply curtailing or ending state investment outlays from the state budget probably would be least difficult to accomplish, and would serve two additional important purposes in the short run. It would build on Poland's earlier reform efforts to shift investment funding from budget grants to bank loans. By first going after outlays that many view as squandered or mismanaged by the state, it also would help send the message to the public that the new government's reforms will be more than just another round of punitive price hikes.

Bolstering Consumer Supplies. The government must improve food supplies in order to minimize hoarding and panic buying. Many foods now seem to be in better supply but at much higher prices. Still, meat production in 1989 is expected to fall as much as 6 percent, and despite apparently good harvest prospects, some other shortages are likely. Warsaw will have to monitor market supplies; some hard currency food imports, in addition to scheduled Western aid, may be necessary.

Midterm Measures

After addressing its most visible problems, the government will have to move quickly to develop and promote an overall reform package. Financial reforms that improve operations of all sectors should be a priority, as should agricultural reforms to free private farmers from land sales restrictions and improve supplies of agricultural inputs. Encouragement of private enterprise and foreign investment can proceed on the basis of existing legislation. As Poland moves on these fronts, it will have to lay the groundwork for state-sector reform.

Financial Reforms. Financial reforms should be a priority, as they would facilitate other reforms elsewhere in the economy:
- The National Bank of Poland needs independence from political pressures to stabilize government spending.
- Interest rates must provide a "real" rate of return to attract savings and to place a real cost on borrowing.
- Banks must begin to evaluate loan applications in terms of risk and expected return.
- Loans must be made as available to private enterprise as they are to the state sector.
- Use of the undervalued official exchange rate should be abolished.

Encouragement of Private Enterprise and Foreign Investment. Private entrepreneurs and foreign investors would be reassured if the government quickly stated its support for reform legislation already in place. Continued growth in these areas might provide significant early boosts to Poland's export earnings and make a dent in some consumer goods shortages. The most valuable benefit of continued growth here, however, could be the impact on the state sector. New, larger private enterprises and joint ventures could provide an example to state industry of how reforms should work. Obvious successes could increase worker and management willingness to adopt market reforms in the state sector. Rapidly growing private and foreign sectors also could provide attractive new opportunities for employment and absorb workers from state industry who will be laid off when other money-losing enterprises are shut down.

Another way for the new government to increase opportunities for foreign investment would be the establishment of special trade zones—designated regions where joint ventures and foreign investors receive special tax breaks and other operating incentives. If they were located in coastal zones, they would serve to minimize the extent to which poor internal transport works against export and import deliveries. Special trade zones also would stimulate Poland to better focus investment outlays on modern infrastructure—telecommunications and utilities—and on financial and other service-sector support for joint ventures.

State-Sector Industry. Poland needs to focus on preparations for change in the state sector and to devise a consistent approach before going all-out in such areas as decontrolling prices, laying off workers, or shutting down unprofitable enterprises. Before letting markets determine prices and outputs, the ground rules must be in place and impediments to smooth market operations—barriers to entry, imperfect market knowledge, monopoly power of participants—need to be minimized in order to avoid inflation and shortages. The approach taken by the European Community to economic unification could be a useful model—setting a firm deadline for fundamental change and then proceeding methodically to put the pieces in place. As the EC's example demonstrates, this process can have a dramatic and positive effect on the public's mood and expectations.

Components of a comprehensive state reform package probably should include the following:
- The dismantling of central economic ministries.
- The revamping or replacement of the *nomenklatura* system to develop a managerial class responsive to market pressures.
- The codification of the rights of workers, management, and enterprises.
- The breakup of large state enterprises into smaller and more manageable ones.
- The creation of an unemployment compensation system.
- The development of a consistent set of regulations regarding bankruptcy legislation.
- The development of a functioning stock market.
- The stimulation of capital goods and intermediate goods markets.
- The creation of more realistic joint stock company procedures.

Agriculture. To expand farm production and modernize agriculture, Poland needs to liberalize conditions for land sales and to improve farmers' access to inputs by ending priority allocations to state farms. Land reforms that keep pension calculations independent of farmers' disposition of private landholdings are crucial to Poland's private farmers' abilities to consolidate small holdings and capitalize on economies of scale. The sizable amount of land abandoned by emigres must be made available for lease or sale. State farms could be allowed to go private or could be abolished, with land and assets auctioned off.

Price reforms, competition in manufacturing and marketing agricultural inputs, as well as in food processing and distribution, are necessary to increase farmers' profitability and productivity. The agricultural service sector holds great potential for expansion as farmers' earnings grow and allow for reinvestment.

Export Promotion. With the legalization of foreign exchange sales already in effect, Poland over time should increase the share of hard currency earnings kept by exporters—they should receive all of it, but perhaps pay tax in hard currency at an appropriate tax rate. Moreover, ending current restrictions on how exporters can dispose of their foreign exchange earnings could funnel hard currency to more effective uses. At present, firms earning hard currency must spend it themselves. The result is that they are encouraged to import goods available domestically, even as other firms needing imported materials and services have to do without.

Long-Run Perspective

In the long run, Poland needs to create conditions that channel funds and resources to profitable and efficient enterprises, even at the cost of permitting unprofitable ventures to collapse. This will mean a system of laws that guarantees the property rights of individuals and an economy open to the world. Once the prerequisite financial reforms are in place, Poland should move to full convertibility of the zloty to maintain internal and external equilibrium.

The Role of the West

Western assistance to Poland also can be viewed in terms of immediate, midterm, and long-run needs.

Immediate Needs
Poland needs help with food supplies over the next year, particularly meat. The major impact of this aid will be symbolic—a clear and tangible statement of Western support for Poland's new course. Food aid will have to be carefully administered, however, to make sure that Poland's food distribution system is not overwhelmed and to minimize any impact on market prices that might discourage farmers' plans for expansion of livestock herds. To help bolster livestock holdings over the long term, feed grains as well as meat are important.

Midterm Needs
Preparation for market reforms will require enhanced Polish awareness of how Western economies and businesses operate, and Western management training can make a crucial contribution. Western advice in setting up bankruptcy and unemployment legislation and in establishing codes to regulate stock markets and corporate financial practices will also be valuable.

Long-Run Needs
Poland would benefit from debt relief and renewed access to hard currency loans. For its part, the Polish Government must do what it can to repair the confidence of Western bankers and official lenders by putting reforms in place. Meanwhile, the formulation of concrete Western plans for debt assistance and rescheduling—to be carried out once Polish reforms are in place—would both encourage the Polish Government to proceed with reforms and help it gain public acceptance of reform.

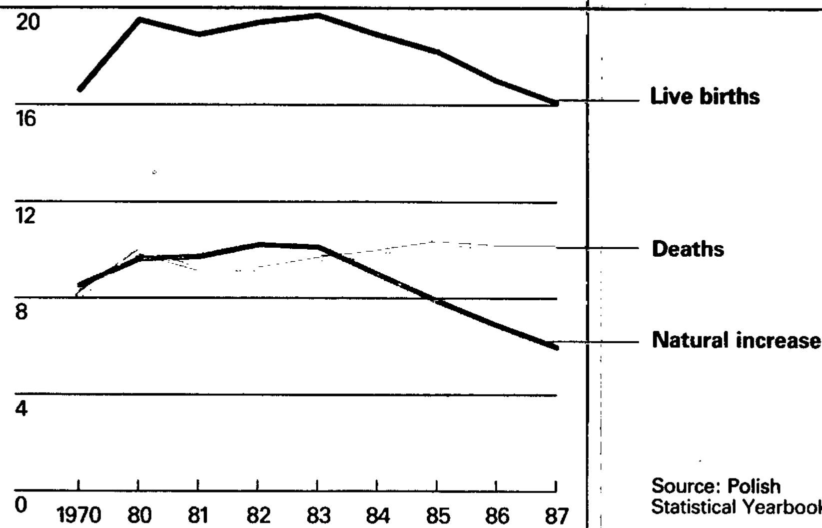
Perspective

Reforms in Poland have a difficult starting point. The foreign debt, inflation, and chronic shortages all work against effective reform policy. But, to the extent that the new government begins laying the groundwork for a long-run economic recovery, it will enhance prospects for public understanding and support. This could provide a much-needed "window of opportunity" to move forward with reforms. Overcoming or eliminating bureaucratic resistance to reform will remain the key difficulty. Communist-led governments also have been increasingly reform oriented, but policy differences within the party or central government have consistently scuttled or slowed the implementation of reforms. Dismantling state ministries and an overhaul of the *nomenklatura* system is thus crucial to the new government's hopes of revitalizing the state sector.

POLAND

4. Vital Population Statistics, 1970-87

Per thousand



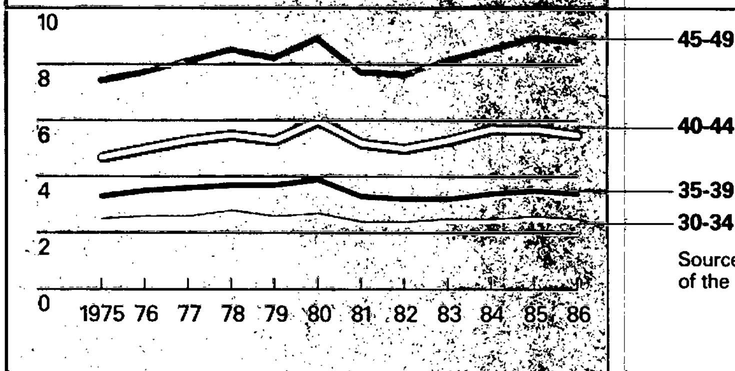
Source: Polish Statistical Yearbook

POLAND

5. Quality of Life Indicators

Male Death Rate by Age, 1975-86

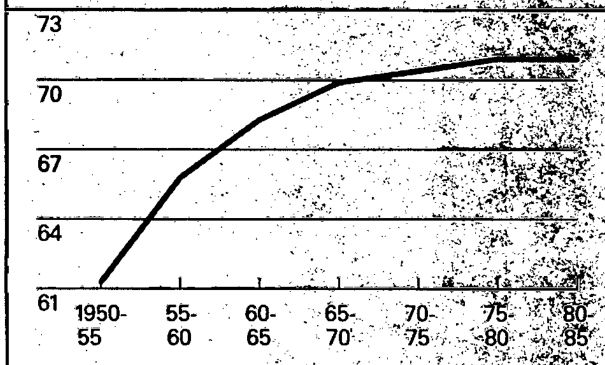
Deaths per thousand



Source: US Bureau of the Census

Life Expectancy, 1950-85

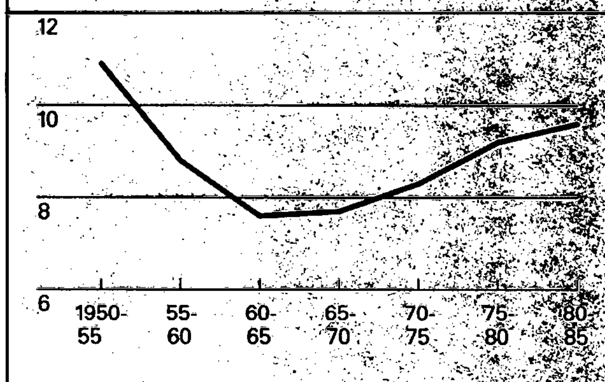
Years at birth



Source: US Bureau of the Census

Average Annual Crude Death Rate, 1950-85

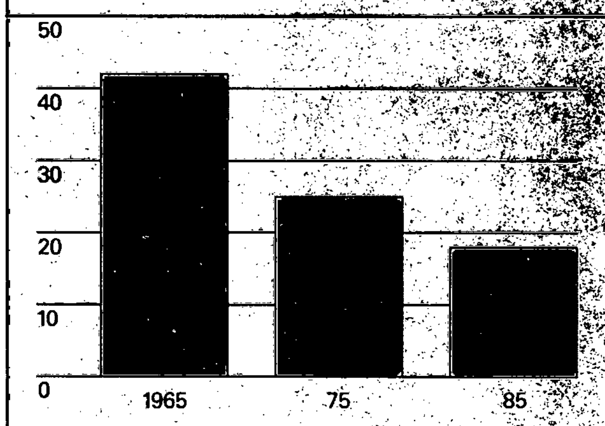
Deaths per thousand



Source: US Bureau of the Census

Infant Mortality, 1965-85

Deaths per thousand



Source: World Bank